The Case for Mexico's Rescue: The Peso Package Looks Even Better Now

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Courtesy Reuters

One often hears claims that U.S. policy toward Mexico has failed. In Harper's, the argument is that the North American Free Trade Agreement (NAFTA) shows the Clinton administration has little concern with 'the continuing hemorrhage of American jobs abroad.' The New York Times deplores 'the rapid unraveling of the Mexican economic achievements of 1988-1993.' Publications across the United States assert that freer trade has increased narcotics trafficking through Mexico. Pundits of the far left and the far right appear regularly on television talk shows asserting that the peso crisis is proof the U.S. policy of economic engagement did not work. They say that Presidents Bush and Clinton were wrong to back NAFTA and to support the privatization of Mexico's state-owned industries, its neoliberal market and investment-friendly development strategies, and the rescue package to contain the winter 1994-95 devaluation and collapse of the peso.

These critics are mistaken about the impact and implications of U.S. policy. NAFTA has not generated and will never generate immediate, large-scale, tangible economic effects--positive or negative. Nor was it ever capable of doing so, as most economists understood. The trade agreement, however, did reaffirm America's commitment to Mexico's economic development, which was to be sorely tested when the peso crashed a year after Congress ratified NAFTA. The U.S.-led rescue, which was hastily put together to counter the peso crisis and which is now creating immediate economic benefits on both sides of the border, is a sound policy with far-reaching effects for Mexico.

Although Mexico's economic development is not assured of success over the next generation, the country has probably turned the corner on its recent crisis. Some forecasters expect its GDP to grow by three percent this year. The unemployment rate peaked in July 1995 and has since declined by more than two percentage points. Exports and imports have adjusted to offset the shutdown of foreign investment the peso crisis triggered; the current account rose to a surplus of $7.4 billion in 1995, from a deficit of $18.5 billion in 1994. Over the same period, exports rose 30 percent and imports fell 10 percent.

WHAT NAFTA MEANT

The trade agreement did not greatly expand Mexico's access to the U.S. market; the market was already largely open to Mexican imports. Rather, NAFTA made Mexican businesses and investors a solemn promise that they would not be bankrupted by a sudden wave of U.S. protectionism.

A more important benefit of NAFTA for Mexico lay in the obligations it placed on future Mexican administrations to continue market-friendly reforms. With the reforms tied to a formal treaty, the chance they would be abandoned was diminished. In developing countries, most of the benefits from market reforms hinge on their perceived and actual permanence. For governments struggling to establish their legitimacy and sustain growth, the worst of all worlds is to enact policies that hurt powerful interests, then fail to reap the benefits because investors and producers fear the policies will be transitory. NAFTA helped avoid this trap.

Critics of NAFTA, such as Texas billionaire and erstwhile presidential candidate Ross Perot, alleged the treaty would endanger some five million American jobs. But U.S. joblessness has declined since NAFTA's implementation. The level of employment in the United States these days is much more the result of Federal Reserve decisions than changes in trade with Mexico. As part of the Clinton administration's NAFTA legislation, the Labor Department set aside money to help displaced workers with retraining and job searches. Through last year, about 35 companies a month had applied for the set-aside funds, and about 2,000 workers a month had received financial aid. These are tiny numbers in the context of the two million workers in the United States who lose their jobs in any one month. Thus NAFTA in 1995 caused perhaps one out of every thousand job losses, an order of magnitude less than the statistical errors in the monthly employment reports.

As for the net gains from NAFTA, virtually all economists agreed with estimates from the Congressional Budget Office that there would be small gains in U.S. GDP and some shifting of workers from relatively low-wage, labor-intensive industries to high-wage, capital-intensive industries. About 0.03 percent of the labor force would shift jobs over the next decade, due to NAFTA. Serious analysts never expected large gains for the United States. In economic terms, Mexico is about the size of Los Angeles.

The benefits for Mexico are relatively much larger. Mexico's growth since 1986 has been based on policy liberalization and trade expansion, which have significantly changed the structure of production and led to dramatic increases in trade with the United States. NAFTA locks in these policy changes, and numerous studies indicate that successful growth and structural change in Mexico increase job creation and reduce pressure for migration to the United States.

During the 1994-95 peso crisis, the benefits for Mexico became more important, not less.

Had it been foreseen during the NAFTA negotiations that foreign capital would flee

Mexico at the end of 1994, the case for NAFTA would have been stronger, not weaker. As a consequence of the crisis, guaranteed access to the U.S. market has become a more important determinant of long-term investment in Mexico, and Mexico's demonstrated commitment to reform policies has become more important for renewed growth.

The peso crisis has raised the stakes for the United States as well. That Mexico is not going to have as easy a time becoming a prosperous industrial democracy as many had hoped four or five years ago makes U.S. support for a policy of economic engagement and steady economic reform all the more important.

THE FALL

In the spring of 1994, Mexico seemed to be doing many things right. Since the mid-1980s it had undertaken major reforms. The government budget had shifted from a substantial deficit to a surplus, thus no longer draining Mexicans' savings pool. State enterprises were being privatized and tariffs lowered. Since 1989 the government deficit had fallen from five percent of GDP to zero, and the inflow of capital had risen from zero to five percent of GDP.

Some leading economists (e.g., Rudiger Dornbusch, Alejandro Werner, Guillermo Calvo, Leonardo Leiderman, and Carmen Reinhart) forecast trouble, however. Inflation and the relatively fixed peso-dollar exchange rate had left Mexico uncompetitive. While foreign investors still viewed Mexico favorably, Mexicans realized that at current exchange rates new foreign direct investment in Mexico was likely to be unprofitable. Mexicans had been taking foreign investors' money, but they were using it to finance increased consumption rather than increased investment. The solution was to devalue the peso by 20 percent and then, to keep Mexico from losing competitiveness again, maintain the real exchange rate by bringing the peso's rate of inflation down to the U.S. inflation rate--a standard prescription of the International Monetary Fund (IMF)and the World Bank.

Throughout the spring and summer of 1994, the administration of Carlos Salinas was preoccupied with the Mexican presidential campaign. Although foreign exchange reserves were falling, the government bet that the drawdown was not a permanent change in foreign investors' demand for Mexican assets. Part of the government's strategy for maintaining confidence in the stability of its exchange rate was to replace conventional short-term borrowing with Tesebonos, short-term securities whose principal was indexed to the dollar, encouraging investors who feared devaluation to keep their capital in the country. In retrospect, this was a double-or-nothing bet. The policy was effective in the short term, but risky: it retained some $23 billion of foreign financing, but ensured that if a devaluation came, it would be deeper and more dangerous.

By the end of 1994, it had become public knowledge that the flow of foreign portfolio capital into Mexico had not resumed. From nearly $30 billion before the assassination of presidential candidate Luis Donaldo Colosio in March 1994, foreign exchange reserves had fallen to perhaps $5 billion. After a tumultuous year that included political assassinations, a tainted presidential election, and a guerrilla uprising in the state of Chiapas, Mexico had nearly reached the bottom of its reserves. Just weeks into his term, the new Mexican president, Ernesto Zedillo Ponce de Leon, announced a devaluation of the peso.

The market reaction was more severe than anticipated. The peso fell 50 percent, far more than the 20 percent economists deemed necessary to restore equilibrium. Each investor in Mexico feared that other investors would pull their money out no matter what the cost, and that the last investors to withdraw would lose the most--through hyperinflation, as the Mexican government frantically printed pesos to cover its peso-denominated debts; through capital controls, which would trap money in Mexico indefinitely and eat up its value; or through formal default, a repeat of Mexico's commercial bank crisis of 1982.

With $5 billion in reserves, $23 billion in Tesebono liabilities, which would be converted into dollars and pulled from Mexico as they matured, and no one willing to lend hard

currency, Mexico faced two painful alternatives. The government could push interest rates sky-high to keep capital in the country, in which case the extraordinary cost of money would strangle investment and employment and quickly bring on a Great Depression. Or it could lose its ability to borrow and start rapidly printing money to meet its obligations, resulting in a spiral of hyperinflation and depreciation, in which case a deep depression would come slowly as hyperinflation eviscerated a productive economy and tore Mexico from the world trade network. To make things worse, the panic began to spread--the so-called tequila effect--raising the possibility that developing countries throughout the world would be forced into strongly contractionary policies leading to deep recessions.

A MEASURE OF SUCCESS

Mexico's predicament was not preordained. At the end of 1994, Mexico's economy was not insolvent, but merely illiquid. If investors had been willing to roll over the country's short-term debt, a combination of contractionary policies and a moderate devaluation to reduce imports and encourage exports would have helped pay the government's foreign liabilities as they came due. Such an approach might have caused a recession (although in Britain in late 1992 it did not), but it would have been much shorter and shallower than the one Mexico faced in the absence of funds to roll over its short-term debt. Lack of liquidity was the problem, and liquidity is what the support package provided: some $40 billion in dollar-denominated assets from the United States, the International Monetary Fund, and other donors, put aside for Mexico to draw on.

The peso support package worked: Mexico registered a $7.4 billion trade surplus in 1995. Real exports were more than 30 percent higher in 1995 than in 1994, while imports fell more than 8 percent. The generation of such an export surplus so quickly resulted from the involuntarily large devaluation of the peso and the squeeze the crisis put on the Mexican economy.

Mexico can now export enough to earn the foreign exchange to repay its debts. Indeed,

governments and international institutions that contributed to the support package are making money--as is generally the case in a genuine liquidity crisis. So far, $750 million in interest payments has flowed into the U.S. Treasury. The Congressional Budget Office forecasts that the support package will reduce, not increase, the U.S. budget deficit. Moreover, Mexico's foreign exchange reserves at the end of January were a healthy $16 billion.

The rescue has not been pain-free. Mexico's moves during the peso crisis to allay foreign investors' skittishness about lending or refinancing have exacted a high cost: the country's GDP in 1995 was seven percent below 1994 levels. However, Mexico's unemployment rates have improved since August, and other data suggest that the worst is over. The severe recession Mexico experienced is much better than the Great Depression the country might have suffered in the absence of the liquidity support package.

Without an international rescue, a major depression in Mexico seemed almost inevitable, and it would almost surely have led to regional slowdowns in California and Texas and a jump in illegal immigration into the United States. There was a chance--how large, no one knew or was willing to estimate--that the crisis would spread to other developing countries. A sudden end to the $150 billion annual flow of private investment from the industrial core of the world economy to the developing nations would likely have caused severe depressions in Latin America and perhaps in Asia.

FAIR ENOUGH

Initially U.S. congressional barons embraced the rescue. But despite almost daily pilgrimages to Capitol Hill by Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan, legislative support unraveled. A Clinton economic initiative that promised to stem an international liquidity crisis, avoid a Great Depression in America's neighbor to the south and a large increase in illegal immigration, avert a potential recession in developing countries throughout the world, avoid regional

slowdowns in Texas and California, and probably make money for the U.S. Treasury turned out to be impossible to push through Congress in early 1995. The Clinton administration shifted to the joint executive branch-IMF rescue package, which used the Treasury Department's Stabilization Fund to provide liquidity to Mexico.

What seemed to excite rage was that the U.S. government wanted to do something to support Mexico and--even worse--investors in Mexico. Xenophobia confused the debate, but the animus behind the current applause lines of the American left and right appears to be the perception that the U.S. government gave a $50 billion bailout to Secretary Rubin's Wall Street friends.

The current Mexican recession does impose an unfair burden of adjustment, even if it is only a shadow of the potential macroeconomic disaster. From 1994 to 1995, real Mexican GDP fell, and the unemployment rate in late 1995 was some three to six percentage points above its mark the previous year. Yet investors in Tesebonos--investors who knew the risks--came out of the crisis whole.

The support package, however, did not make investors richer at others' expense. Stemming financial crises is a positive-sum game: everyone wins. Workers keep their jobs, and small businesses avoid bankruptcy. These benefits are real, and they add more to the sum of human welfare than the appreciation of a few financial assets on Wall Street. To abandon these benefits to make Wall Street investors suffer would be cutting off one's nose to spite one's face.

A rapid and efficient way to impose the burden of the crisis more fairly, without the legal and economic mess of formal default and without increasing the risk of a wider liquidity crisis, would have been nice. Some political analysts say they would have welcomed a formal default by Mexico, in which case creditors would have had to negotiate with the Mexican government for repayment and bear some of the cost. Default negotiations, however, never end quickly, cast a long shadow over a nation's economy, keeping foreign

investment out for up to a decade, and vastly increase the magnitude of the near-term economic losses and depression. Moreover, the default of one developing nation invariably causes investors to perceive more risk in others, causing problems throughout the world. Even with hindsight, however, there was no clear path to a better solution. Alternatives that spread the costs more widely would have amplified them as well.

Part of the problem is that there is no consensus about what constitutes a good economic system. There used to be wide agreement in the United States that the best balance is a 'mixed economy,' in which government provides key investments and services, a safety net, and social insurance, while most of the risks and rewards from enterprise are left to entrepreneurs and investors. Yet post-Cold War Republican rhetoric repudiates this consensus and seeks a retreat to an earlier, less satisfactory form of capitalism, while Democrats fail to defend the mixed economy or put forward a reasoned alternative. The result is a muddle, as in the debate over NAFTA, the Mexican rescue package, and recent U.S. budgets.

Any assessment of what the political firestorm over the peso support package means for future management of the world economy is depressing. Faced with a classic liquidity crisis in which international support would produce huge economic benefits at very little risk, Congress could not step up to the plate. The only positive note is that Congress was equally unwilling to block the rescue package.

Perhaps worse, some of the larger financial powers sounded like the skeptics in Congress, grousing that the Mexican crisis was not a 'systemic problem' and that the rescue package helped those who had made imprudent short-term investments in Mexico. Germany and Britain abstained from the IMF executive board vote that authorized the organization's contribution to the support package. Ultimately the IMF did step up to the plate, approved the program, and has announced its willingness to do likewise again. It may have to. The role of the IMF becomes more crucial when the major economic powers are unable to react quickly to dampen liquidity crises.

INCREASING THE ODDS

The long-term benefits from the economic policies instituted in the 1980s by Mexican president Carlos Salinas remain. Mexico's tariffs and nontariff barriers have been slashed. Restrictions on foreign investment have been lifted. Perhaps 1,000 state-owned enterprises have been privatized. A central government budget deficit of 13 percent of GDP in 1987 has been transformed into a balanced budget, and inflation is down to 27 percent, from 150 percent in 1987.

Relying on foreign capital inflows to finance industrialization, however, is risky. It can lead not only to rapid growth but to deep recessions, as the United States discovered in the 1800s, when it relied heavily on British financing for its industrial and infrastructure development and was subjected periodically to devastating financial crises. In addition, the Mexican banking sector remains under considerable strain, inflation is a persistent problem, and unemployment and underemployment remain very high.

The Mexican political system may collapse under the weight of economic and political liberalization and the extra burden created by the peso crisis. Noting the assassinations of Cardinal Posadas, Luis Donaldo Colosio, and Jose Francisco Ruiz Massieu, commentator Jorge Castaeda has concluded that nonviolent dispute resolution mechanisms among Mexican elites are in 'a terminal state of dysfunction.' Should the Mexican political system collapse, what follows may not be better, economically or politically.

More likely, Mexican politics will muddle along toward greater democracy. And whatever Mexico's destiny, it is surely better off because of the economic engagement the past two U.S. administrations pursued. NAFTA has increased the odds that successive Mexican governments will continue to dismantle the structures of government control and political influence that have been a drag on Mexico's growth. More important, NAFTA has increased the odds that foreign investors will believe Mexico is committed to pro-growth policies. It has boosted Mexico's ability to draw on the world's savings to finance further investments directed toward long-term productivity growth.

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